89-1738

Supreme Court, U.S.
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In the
Supreme Court of the United States

October Term, 1990

IN RE:
JOSEPH M. EATON BUILDERS, INC.,
Debtor.

JAMES A. LEWIS, ESQUIRE
TRUSTEE FOR JOSEPH M. EATON
BUILDERS, INC.
Petitioner,

v.

THOMAS J. and LINDA M. DIETHORN,
Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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QUESTION PRESENTED

Did the United States Court of Appeals for the Third Circuit err in holding that a debtor's payment made within ninety (90) days of bankruptcy filing for the express purpose of settling pending litigation was not payment on an antecedent debt and was such holding in conflict with the same court's holding in *In re Johnson-Allen*, 371 F.2d 421 (3d Cir.) *cert. granted*, ___U.S.___, 110 S. Ct. 49, 107 L.Ed 2d 18 (October 2, 1989)?

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PETITION FOR A WRIT OF CERTIORARI

To The United States Court of Appeals

FOR THE THIRD CIRCUIT

Petitioner, James A. Lewis, Trustee for Joseph M. Eaton Builders, Inc. respectfully prays that a Writ of Certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Third Circuit entered in this proceeding on January 12, 1989.

OPINIONS BELOW

The February 13, 1990, Order of the United States Court of Appeals for the Third Circuit denying rehearing or rehearing in banc is reprinted in Appendix A hereto at 1a, infra.

On January 12, 1989, the United States Court of Appeals for the Third Circuit entered its judgment and opinion which is reported at 893 F.2d 648 (3d Cir. 1990) and is reprinted in Appendix B hereto at 3a, infra.

The July 12, 1989, judgment of the United States District Court for the Western District of Pennsylvania affirming the United States Bankruptcy Court decision, which is not officially reported, is reprinted in Appendix C hereto at 11a, infra.

The December 6, 1988, United States Bankruptcy Court Opinion and Order granting the Trustee's request to avoid preferential payment, which is not officially reported, is reprinted in Appendix D hereto at 15a, infra.

JURISDICTIONAL STATEMENT

The United States Court of Appeals for the Third Circuit entered its judgment on January 12, 1990, and, on February 13, 1990, it denied Petitioner's Petition for Rehearing. The Third Circuit's decision misinterprets an important question of Federal law which has not been, but should be, settled by this Court. Further, the Third Circuit's decision is in direct conflict with the decision of at least one other United States Court of Appeals concerning the definition of an antecedent debt under Section 547 of the United States Bankruptcy Code. This Court has jurisdiction to review the judgment pursuant to 28 U.S.C. § 1254(1).

STATUTE INVOLVED

The Bankruptcy Code's definition of an avoidable preference under 11 U.S.C. § 547(b), provides in relevant part:

> (b) Except as provided in subsection (c) of this section, the trustee may avoid any transfer of an interest of the debtor in property—
>
> (1) to or for the benefit of a creditor;
>
> (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
>
> (3) made while the debtor was insolvent;
>
> (4) made—
>
> (a) on or within ninety (90) days before the date of the filing of the petition . . .
>
> (5) that enables such creditor to receive more than such creditor would receive if—

(a) the case were a case under chapter 7 of this title;

(b) the transfer had not been made; and

(c) such creditor received payment of such debt to the extent provided by the provisions of this title.

11 U.S.C. § 547(b)(1986).

STATEMENT OF THE CASE

In 1985, Joseph M. Eaton Builders, Inc. ("Debtor") as Seller, and Respondents, Thomas J. and Linda M. Diethorn as Buyers, executed an agreement for the sale of a certain residence and real estate located in Allegheny County, Pennsylvania. Subsequently, a dispute arose between the parties, and the Respondents instituted a suit in Equity against the Debtor in the Court of Common Pleas of Allegheny County and caused the suit to be indexed *lis pendens* (the "State Court Action"). The Complaint, *inter alia*, sought specific performance of the Agreement of Sale and demanded that the Debtor escrow $13,000.00 to cover certain costs. (Appendix G). The Debtor contested the allegations of breach and filed a Counterclaim.

The parties then entered into settlement negotiations regarding the State Court Action. By Consent Order dated February 26, 1987, the Debtor agreed to pay the Respondents $15,500.00 and return the Respondents' $3,000.00 earnest money. In exchange, Respondents agreed to discontinue the litigation and cancel the *lis pendens*. The Respondents, therefore, filed a Petition to Cancel the *lis pendens*, which stated that they were aware that the Debtor was "contemplating bankruptcy and [Respondents] seek to

mitigate those damages by canceling the said *lis pendens* and receiving said monies at this time." (Appendix F at 35a).

On February 26, 1987, the Debtor paid the Respondents $15,500.00 and returned the $3,000.00 earnest money. Only five (5) days after payment to the Respondents, on March 3, 1987, the Debtor filed a voluntary Petition under Chapter 7 of the Bankruptcy Code. A timely preference action was commenced by filing a Complaint in an adversary proceeding demanding the return of the $15,500.00, together with interest thereon. (Appendix E).

The Respondents contested the avoidability of the preference payment, and hearings were held before the Honorable Judith Fitzgerald of the United Sates Bankruptcy Court on January 26, 1988, and on September 30, 1988. On December 6, 1988, that Court issued an Order granting the Trustee's request and directing the Respondents to return the $15,500.00 to the Trustee. (Appendix D at 26a). The Respondents filed an appeal to the United States District Court alleging that the preference was not avoidable. On July 12, 1989, the District Court issued an Order affirming the Bankruptcy Court Order. (Appendix C at 14a).

The Respondents filed an appeal from the District Court's Order to the United States Court of Appeals for the Third Circuit. On January 12, 1990, the Third Circuit issued an Opinion reversing the District Court holding that the payment by the Debtor to the Respondents was not "for or on account of an antecedent debt owed by the debtor before such transfer was made." (Appendix B at 7a). Instead, the Court of Appeals stated that the payment was made for the Respondent's "undertaking to terminate the lawsuit . . . and so to remove the *lis pendens* . . . What

[the Debtor] received was not freedom from liability on an antecedent debt, but the freedom from the risk of litigation." (Appendix B at 7a). The Third Circuit thus found that the settlement of the pending law suit was a contemporaneous transfer and that payment was not upon an antecedent debt and not performed under Section 547 of the Bankruptcy Code.

As a result of the Third Circuit's decision which is inopposite to the weight of authority, Petitioner now respectfully requests a Writ of Certiorari to the United States Court of Appeals for the Third Circuit.

REASONS FOR GRANTING THE WRIT

A. The Third Circuit's Standard, Redefining the Term Antecedent Debt, Effectively Rewrites Section 547 of the Bankruptcy Code in a Way Not Contemplated by the Statute, Opening the Way for an Increase in Lawsuits Prior to Bankruptcy.

This Court should issue a Writ of Certiorari because the Third Circuit has redefined the term "antecedent debt," in a manner which undermines a basic tenet of bankruptcy law.

Section 547 of the Bankruptcy Code, 11 U.S.C. § 547, has never been expressly reviewed by this Court. This is not surprising, given the straightforward language of Section 547, its clear legislative history, and the plethora of cases concerning the definition of an antecedent debt. In fact, the Bankruptcy Court correctly found that:

> [Respondents] are creditors of the Debtor inasmuch as they have a claim against Debtor which arose prepetition . . . The transfer is *prima facie* a preferential

> transfer avoidable by the Trustee. (Appendix D at 19a).

The United States District Court for the Western District of Pennsylvania also found that the Respondents held "nothing more than an avoidable preference." The District Court held that:

> We find that although the [Respondents'] claim may have become a judgment lien, the [Respondents'] had nothing more than a *lis pendens* against [the Debtor] at the time of settlement. Therefore, the settlement within the statutory period could be construed as nothing more than a voidable preference. (citations omitted) (Appendix C at 13a).

The Respondents never argued that the money owed was upon anything but an antecedent debt. Indeed, the Respondents seemingly admit that none of the elements for a finding of preferential payment, including the requirement that the debt be for or on account of an antecedent debt, were missing.

Nevertheless, the Third Circuit redefined "antecedent debt" in order to allow the Respondents to keep the preferential payment. The Third Circuit's new definition provides a mechanism for debtors to pay friendly creditors, who could then avoid disgorging the preferential payment. This definition directly conflicts with legislative intent.

As is noted in the legislative history to the Bankruptcy Reform Act of 1978[1], the Bankruptcy Code's definition of a "claim"[2] was intended to be "the broadest possible definition . . . [so] that all legal obligations of the debtor, no matter how remote or contingent, will be able to be dealt

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[1]Pub. L. No. 95-598, 92 Stat. 2549 (1978).

[2]Codified at 11 U.S.C. § 101(4).

with in the bankruptcy case." H.R. Rep. No. 595, 95th Cong., 2d Sess. 309 (1977), *reprinted in* 1978 U.S. Code Cong. & Admin. News 5963, 6266; *see also*, S. Rep. No. 989, 95th Cong., 2d Sess. 21-22 (1978), *reprinted in* 1978 U.S. Code Cong. & Admin. News 5787, 5807-08. "Claims" also embraces equitable rights to performance in addition to actual or potential legal rights to damages. S. Rep. No. 989 at 22, 1978 U.S. Code Cong. & Admin. News at 5808. By its plain language, Section 101(4) defines a "claim" under the Bankruptcy Code to include:

> [a] right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured . . . .

11 U.S.C. § 101(4).

Section 101(11) of the Code also defines a "debt" as a "liability on a claim." 11 U.S.C. § 101(11). The legislative history clearly shows that the definitions of a "claim" and a "debt" are coextensive when a creditor has a claim against a debtor, the debtor has incurred a debt to the creditor. H.R. Rep. No. 595 at 310, 1978 U.S. Code Cong. & Admin. News at 6267; *see also* S. Rep. No. 989 at 23, 1978 U.S. Code Cong. & Admin. News at 5809.

In short, Section 101(4) embraces contingent, disputed and unliquidated claims, such as the one involved here. Congress clearly intended that the Bankruptcy Code reach these claims in order to be able to provide "the broadest possible relief." H.R. Rep. No. 595 at 309, 1978 U.S. Code Cong. & Admin. News at 6266. The Third Circuit's holding redefining antecedent debt narrows the scope of claims encompassed by Section 101(4). This clearly does not provide the broadest possible relief.

In fact, the Third Circuit's decision undermines the foundation of bankruptcy law:

> The purpose of the preference section is two-fold. First, by permitting the trustee to avoid pre-bankruptcy transfers that occur within a short period before bankruptcy, creditors are discouraged from racing to the courthouse to dismember the debtor during his slide into bankruptcy. The protection thus afforded the debtor often enables him to work his way out of a difficult financial situation through cooperation of all of his creditors. Second, and more important, the preference provisions facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor. Any creditor that received a greater payment than others of his class is required to disgorge so that all may share equally. The operation of the preference section to deter "the race of diligence" of creditors to dismember the debtor before bankruptcy furthers the second goal of the preference section—equality of distribution.

H.R. Rep. No. 595 at 177-78, 1978 U.S. Code Cong. & Admin. News at 6138. By removing the payment at issue in this case from the realm of claims recognized in bankruptcy, the Third Circuit allows unrecorded liens to be recognized in bankruptcy. Giving effect to these "secret liens" undermines the fundamental policies of deterring the "race of diligence" among creditors and of equality of distribution.

The legislative history of the Bankruptcy Reform Act of 1978 shows that Congress intended to discourage recognition of such "secret liens." The legislative commentary to the Bankruptcy Code's definition of a "lien"[3] states that

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[3]Codified at 11 U.S.C. § 101(33).

"[i]n general, the concept of lien is divided into three kinds of liens: judicial liens, security interests, and statutory liens. *These three categories are mutually exclusive and are mutually exhaustive* except for certain common law liens." H.R. Rep. No. 595 at 312, 1978 U.S. Code Cong. & Admin. News at 6269 (emphasis added); *see also* S. Rep. No. 989 at 25, 1978 U.S. Code Cong. & Admin. News at 5811.

The Bankruptcy Code's definition of a "judicial lien" states that a judicial lien is obtained "by judgment, levy, sequestration, or other legal or equitable process or proceeding." 11 U.S.C. § 101(32). The Respondents never obtained a judgment. They merely obtained a *lis pendens*. Accordingly, they did not have a "judicial lien" against the Debtor in the bankruptcy sense.

A "security interest" is defined as a "lien created by an agreement." 11 U.S.C. § 101(44). The Respondents' *lis pendens* did not arise by agreement with the Debtor; therefore, the Respondents did not have a "security interest," as defined by the Bankruptcy Code.

A "statutory lien" is defined as a "lien arising *solely* by force of a statute on specified circumstances or conditions. . . ." 11 U.S.C. § 101(47) (emphasis added). The Respondents' suit against the Debtor did not have a statutory basis. Therefore, there could be no "statutory lien."

In short, the Respondents' claim did not fit into any of the three categories of liens defined by the Bankruptcy Code, categories that are "mutually exhaustive".

Judicial liens, security interests and statutory liens all have one thing in common, parties who may have claims against a debtor are put on actual or constructive notice of the possible existence of these liens before extending

money, goods, services, or credit to the debtor. None of these considerations, however, apply to the restitutionary "lien" at issue here. It simply attaches without giving notice. This cannot be permitted.

If a bankruptcy trustee cannot avoid transfers made shortly before bankruptcy to satisfy the holder of a "secret" lien, creditors will be encouraged to attempt to get what assets they can before the filing of a Petition. The Third Circuit's decision, however, does more than just encourage Creditors to win "the race of diligence."[4] The Third Circuit's decision will virtually invite creditors of a potential bankrupt to engage in collusive lawsuits in order to attempt to establish the kind of "secret" liens that the Third Circuit has upheld.

For the aforementioned reasons, the Petitioner respectfully urges this Court to grant its Petition for Writ of Certiorari.

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[4]The above considerations are enough to dispose of the alternate ground advanced by the Third Circuit to support its decision in this case: that, under Pennsylvania law, an equitable lien would have arisen that would have defeated a hypothetical judgment lien creditor of Petitioner on the date when the Bankruptcy Petition was filed. (Appendix B at 9a.-10a). In bankruptcy, the existence and power of liens is controlled by state law, *unless its application would frustrate a federal policy. See,* U.S. Const. Art. I, § 8, cl. 4; U.S. Const. Art. VI, cl. 2; *In re Bullion Reserve of N.Am.*, 836 F.2d 1214, 1218 (9th Cir.), *cert. denied,* 486 U.S. 1056 (1988); *Elliott v. Bumb,* 356 F.2d 749, 755 (9th Cir.), *cert. denied,* 385 U.S. 829 (1966). Application of the lien in this case would frustrate both Federal policies which Congress has said are the foundation of the law of preferences: to deter the "race of diligence" among Creditors and to ensure equal distribution among Creditors.

B. The Third Circuit's Decision Creates a Conflict Between the Circuits That Imperils the Uniform Administration of the Bankruptcy Laws.

As the preceding makes clear, the decision of the Third Circuit ignores the express language of Section 547 and the legislative history concerning the definition of an antecedent debt. The language of Section 547 is so specific that the courts which have dealt with the issue of antecedent debt have unanimously found that a payment made to settle a lawsuit is considered antecedent under Section 547. In fact, because the language of Section 547 is so clear, this issue has only been before two circuit courts, the Seventh Circuit and, now, the Third Circuit. The Seventh Circuit, in the case of *In re Energy Cooperative, Inc.*, 832 F.2d 997 (7th Cir. 1987), followed the express language of Section 547 and the unanimous holdings by numerous bankruptcy courts and found that such a payment was for or on account of an antecedent debt.

The Third Circuit, however, held that the payment by the Debtor to the Respondents was not a preference under Section 547 of the Bankruptcy Code because the payment was not "for or on account of an antecedent debt owed by the Debtor before such payment was made." (Appendix B at 7a). The Third Circuit reasoned that:

> [Debtor] paid the . . . [Respondents] in exchange for their undertaking to terminate the lawsuit . . . and so to remove the *lis pendens* from the property index. *What [the Debtor] received was not the freedom from liability on an antecedent debt, but the freedom from the risk of litigation. . . .*

Id. (emphasis added). The Third Circuit's reasoning is contrary to the position taken by the only other circuit court to

confront the question of whether a payment made to settle a lawsuit was a preferential transfer.

In *Energy Cooperative*, the debtor anticipatorily repudiated a contract that it had entered into with a crude oil supplier. No oil was ever delivered to the debtor, but the supplier stated its intention to hold the debtor liable for damages resulting from the debtor's breach. The parties eventually settled their dispute, and the debtor paid the supplier approximately $1.6 million as compensation for the breach. The debtor filed a voluntary Petition for Bankruptcy less than ninety (90) days later. 832 F.2d at 999.

The trustee brought a timely preference action against the supplier to recover the preference payment. The District Court held that, because the debtor had never received any oil, there was no antecedent debt. Instead, the District Court held that the debtor had paid the money to the supplier for the present consideration of settlement of the claim. 832 F.2d at 1000.

The Seventh Circuit reversed. 832 F.2d at 1005. The Court observed that the Bankruptcy Code defines a "claim" to include *any* right to payment, whether unliquidated, contingent, or disputed. 832 F.2d at 1001 *(citing* 11 U.S.C. § 101(4)(A)). The Code also defines a "debt" as a "liability on a claim." 11 U.S.C. § 101(11). The Court therefore held that "when a creditor has a claim against a debtor—even if the claim is unliquidated, unfixed, or contingent—the debtor has incurred a debt to the creditor." 832 F.2d at 1001. Since Illinois law allowed an injured party to recover damages for a repudiated contract, the Court held that at the moment of breach, the supplier acquired a claim against the debtor; accordingly, the debtor also incurred a debt to the supplier. 832 F.2d at

1002. Because the debtor's payment applied to an antecedent debt, the trustee could reach it as an avoidable preference. *Id.*

The *Energy Cooperative* Court also held that the debtor's payment was not within the "contemporaneous exchange for new vlaue" exception to the trustee's avoidance power provided by Bankruptcy Code § 547(c)(1). Because the compromise of the supplier's claim was not "money or money's worth in goods, sevices or new credit," and because the compromise was not a transfer of property to the debtor that the debtor had previously transferred to the supplier, the Court held that the compromise did not fit the definition of "new value" given by § 547(a)(2) of the Code. 832 F.2d at 1002-1003. Because § 547(a)(2) is the exclusive definition of "new value" for bankruptcy preference purposes, 832 F.2d at 1003, the "contemporaneous exchange for new value" exception did not apply to the compromise of the supplier's claim. *Id.*

The Seventh Circuit thus held that a payment to settle litigation was payment on an antecedent debt. The Seventh Circuit also held that the goodwill that may result from satisfaction of a claim is not "new value" under Section 547 of the Bankruptcy Code.

By contrast, the Third Circuit held that a payment made to settle actual or potential lawsuits is made in exchange for the "freedom from the risk of litigation". Further, the Third Circuit at least implicitly views freedom from the risk of litigation as being included in Section 547(a)(2)'s definition of "new value," despite that Section's plain language to the contrary. Clearly, the Third and Seventh Circuits are in conflict.

This conflict is surprising, given the plain language of Section 547. In fact, this issue has rarely arisen and where it has, the Courts have unanimously adopted the Seventh Circuit's position. *See In re Bob Grissett Golf Shoppes, Inc.*, 44 Bankr. 156, 158 (Bankr. E.D. Va. 1984) (payment made to Debtor to settle a claim for breach of contract was for an antecedent debt); *In re Bridges Enters., Inc.*, 44 Bankr. 979, 984-85 (Bankr. S.D. Ohio 1984) (payment made by Debtor to settle unspecified litigation was payment on antecedent claim); *In re Vasu Fabrics, Inc.*, 39 Bankr. 513, 516-18 (Bankr. S.D. N.Y. 1984) (payment made by Debtor to settle a copyright infringement claim was for an antecedent debt). *See also In re Bullion Reserve of N.Am.*, 836 F.2d 1214 (9th Cir.), *cert. denied*, 486 U.S. 1056 (1988) (payment made to cash out participant's position in a Ponzi scheme is payment on an antecedent debt); *In re Heincy*, 78 Bankr. 246 (Bankr. 9th Cir.), *aff'd*, 78 Bankr. 676 (9th Cir. 1987) (restitution ordered pursuant to state criminal law is claim on antecedent debt for bankruptcy purposes); *In re Hackney*, 83 Bankr. 20 (Bankr. N.D. Cal. 1988) (restitution ordered pursuant to state criminal law is claim on antecedent debt for bankruptcy purposes); *In re Kayajanian*, 27 Bankr. 711 (Bankr. S.D. Fla. 1983) (payment on promissory note to comply with restitution order of state criminal court is avoidable preference in bankruptcy).

There is clearly a conflict between the Circuits. Not only are the Third and Seventh Circuits holdings conflicting, but numerous other Courts have adopted the Seventh Circuit's view. In light of this conflict, the Petitioner respectfully requests that this Court issue a Writ of Certiorari to clarify the definition of an antecedent debt.

C. The Third Circuit's Decision in This Case is in Direct Conflict with the Same Circuit's Decision in *In re Johnson-Allen*, Upon Which Certiorari Has Been Granted by This Court.

The Third Circuit's decision conflicts with its prior decision dealing with the definition of debt in, *In re Johnson-Allen*, 871 F.2d 421 (3d Cir.), *cert. granted*, ___ U.S. ___, 110 S. Ct. 49, 107 L.Ed. 2d 18 (October 2, 1989).

Johnson-Allen was decided by the Third Circuit almost a year before this case. The facts of *Johnson-Allen* dealt with a debtor, who was obligated to make restitutionary payments to the Pennsylvania Department of Welfare, after pleading guilty to the crime of welfare fraud. In discussing the definition of "debt," the Third Circuit noted that:

> [w]ithout resolving the issue, the Supreme Court recently lent this position some credence when it declared that it had 'serious doubts' as to whether Congress intended restitution obligations to constitute debts.

871 F.2d at 424, *citing, Kelly v. Robinson*, 479 U.S. 36, 50, 107 S. Ct. 353, 361, 93 L.Ed. 2d 216 (1986). Nonetheless, the Third Circuit concluded that a restitution obligation constitutes debt.

Thus, the Third Circuit in *Johnson-Allen* defined debt in the broadest possible way. On the other hand, by finding the payment by the Respondents to the Debtor not to be for or on account of an antecedent debt in the instant case, the Third Circuit has taken a very narrow view of the definition of debt. The Third Circuit's opinions regarding debt are, therefore, conflicting.

Johnson-Allen is already pending before this Court. This Court should grant certiorari and review this case in conjunction with *Johnson-Allen* in order to put to rest the conflict over "debt" which the Third Circuit has so poignantly demonstrated.

Respectfully submitted,

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Appendix A

United States Court of Appeals

FOR THE THIRD CIRCUIT

No. 89-3561

JAMES A. LEWIS, ESQUIRE, TRUSTEE
FOR JOSEPH M. EATON BUILDERS, INC.

v.

THOMAS J. and LINDA M. DIETHORN,
Appellants,

(D.C. Civil Nos. 89-584 and 89-647)

SUR PETITION FOR REHEARING

Present: HIGGINBOTHAM, *Chief Judge,*
SLOVITER, BECKER, STAPLETON,
MANSMANN, GREENBERG, SCIRICA, COWEN,
and NYGAARD, *Circuit Judges,*
WALDMAN*, *District Judge*

*As to panel rehearing only.

The petition for rehearing filed by appellee in the above-entitled case having been submitted to the judges who participated in the decision of this Court and to all the other available circuit judges of the circuit in regular active service, and no judge who concurred in the decision having asked for rehearing, and a majority of the circuit judges of the circuit in regular service not having voted for rehearing, the petition for rehearing by the panel and the Court in banc, is denied.

BY THE COURT,

/s/ A. SCIRICA
Circuit Judge

Dated: February 13, 1990

Appendix B

Filed: January 12, 1990

United States Court of Appeals

FOR THE THIRD CIRCUIT

No. 89-3561

JAMES A. LEWIS, ESQUIRE, TRUSTEE
FOR JOSEPH M. EATON BUILDERS, INC.

v.

THOMAS J. and LINDA M. DIETHORN,
Appellants,

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF PENNSYLVANIA (D.C. Civil Nos. 89-584 and 89-647)

Submitted Under Third Circuit Rule 12(6)
January 9, 1990
Before: GIBBONS, *Chief Judge,*
SCIRICA, *Circuit Judge*
and WALDMAN, *District Judge**

(Opinion Filed: January 12, 1990)

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---

*Hon. Jay C. Waldman, United States District Judge for the Eastern District of Pennsylvania, sitting by designation.

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OPINION OF THE COURT

GIBBONS, *Chief Judge:*

In this dispute a trustee in bankruptcy has sought to exercise his powers to avoid, as a preferential transfer, the debtor's payment to settle litigation in Pennsylvania court and so to remove a *lis pendens* on certain real estate, for the sale and purchase of which he had entered into a contract with the defendants. The trustee prevailed in bankruptcy court, and the district court affirmed. We will reverse.

I.

Thomas J. and Linda M. Diethorn, the defendants here, entered into a contract with a developer, Joseph M. Eaton Builders, Inc. They paid $3,000 as earnest money into escrow with the real estate agent. By terms of the agreement, the Diethorns were to buy a lot in Allegheny County, Pennsylvania, and a house which Eaton was to build on it. The Diethorns were to pay a total of $182,400, and Eaton was to convey title after building the house. The Diethorns secured a mortgage commitment and in April 1986 they moved into the house. A dispute arose about the

cypress wood siding of the house, the Diethorns contending that it was defective and Eaton refusing to alter it. In May 1986 the Diethorns sued in equity in Pennsylvania state court, seeking specific performance of the Agreement of Sale, and at the same time a *lis pendens* was indexed. The prospective mortgagee made the mortgage commitment contingent upon Eaton's putting $15,000 into escrow for repair of the siding, after the mortgagee's appraiser reported that it was not of workmanlike quality. Eaton did not escrow the money, and the Diethorns lost their mortgage commitment. Meantime they had paid $31,500, in round figures, of their own money to Eaton, some of it to reconstruct the siding and some for other permanent improvements to the house. However, the sales transaction was never consummated, and in July 1986 the Diethorns moved out.

In February 1987 Eaton entered into a settlement agreement with the Diethorns, arranging for the return of their $3,000 earnest money, and paying them an additional $15,500. In return, the Diethorns agreed to discontinue their suit in Pennsylvania state court (a consent order to that effect was entered on February 26, 1987) and to lift the *lis pendens* on the property. That same month Eaton sold the property to another buyer for $205,000.

On March 3, 1987 Eaton filed for voluntary bankruptcy under chapter 7 of the Bankruptcy Code. When the trustee had been duly appointed, he filed a timely complaint against the Diethorns, to avoid the transfer as preferential under section 547 of the Bankruptcy Code and to

recover the $15,500[1] for the bankrupt's estate, thus commencing this adversary proceeding. The proceeding came to trial in the Bankruptcy Court on January 26, 1988 and on December 6, 1988 the court entered a memorandum opinion and order of judgment for the trustee. By order of July 12, 1989, on appeal, the U.S. District Court for the Western District of Pennsylvania affirmed.

II.

Section 547 of the Bankruptcy Code specifies when a payment by a bankrupt debtor may be avoided by the trustee.[2] The transfer of the $15,500 from Eaton to the

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[1]The complaint also sought recovery of the $3,000 earnest money, which the debtor had arranged to release from escrow, but the trustee later abandoned this claim, conceding that the defendants had not breached the contract of sale. Also, the docket entry in the Pennsylvania Court of Common Pleas lists the amount of Eaton's payment to the Diethorns as $15,000, but some pleadings in this bankruptcy case set the amount of the trustee's remaining claims at $15,500; sometimes the total of those claims and the earnest money is given as $18,500. The Bankruptcy Court used the higher figure and, in its judgment order, gave recovery of $15,500 to the trustee. App. 209a; *see also* Mem. Op., Dec. 6, 1988, at 4 n. 5; App. 199a.

[2]The portions of the section pertinent to this litigation read as follows:

§ 547. *Preferences*

***

(b) Except as provided in subsection (c) of this section, the trustee may avoid any transfer of property of the debtor—

(1) to or for the benefit of a creditor;

(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;

(3) made while the debtor was insolvent;

(4) made—

(A) on or within 90 days before the date of the filing of the petition...; and

(5) that enables such creditor to receive more than such creditor would receive if—

(Continued on next page)

Diethorns does not meet the statutory specifications. To be sure, it was a transfer of Eaton's property, to or for the benefit of the Diethorns, made while the debtor was presumptively insolvent and within 90 days before the filing of the petition in bankruptcy. *See* 11 U.S.C. § 547(b)(1), (3), (4) (Supp. V 1987). But it was not "for or on account of an antecedent debt owed by the debtor before such transfer was made." 11 U.S.C. § 547(b)(2). Eaton paid the $15,500 to the Diethorns in exchange for their undertaking to terminate the lawsuit in Pennsylvania court and so to remove the *lis pendens* from the property index. What Eaton received was not the freedom from liability on an antecedent debt, but the freedom from the risk of litigation, together with the rise in the value of the property which resulted when the *lis pendens* was lifted.

Thus, the exchange also falls within the statutory exception to the trustee's avoidance powers as set out in subsection (c)(1), since it was intended by both parties "to be a contemporaneous exchange for new value...and [was] in fact a substantially contemporaneous exchange." 11 U.S.C. § 547(c)(1). The trustee may not avoid such transfers. *Id.*

(Continued)

> (A) the case were a case under chapter 7 of this title;
>
> (B) the transfer had not been made; and
>
> (C) such creditor received payment of such debt to the extent provided by the provisions of this title.
>
> (c) The trustee may not avoid under this section a transfer—
>
> (1) to the extent that such transfer was—
>
> (A) intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor; and
>
> (B) in fact a substantially contemporaneous exchange... .

11 U.S.C. § 547(b), (c) (Supp. V 1987).

III.

We are confirmed in our holding by our finding that even if the transfer had been for an antecedent debt it would have been in satisfaction of an equitable lien, an obligation which would also have defeated the trustee's avoidance power. It would thus have been protected because it would not have been a transfer which "enables such creditor to receive more than such creditor would receive" in a chapter 7 distribution. 11 U.S.C. § 547(b)(5) (1982). "The trustee in bankruptcy is vested by operation of law only with that title which the bankrupt had in his property as of the date he filed the petition. That title is subject to the imposition of equitable liens." *In re Czebotar,* 5 Bankr. 379, 382 (Bankr. E.D. Wash. 1980). It does not matter that the Pennsylvania Court of Common Pleas never imposed an equitable lien, nor does it matter that the suit in the Pennsylvania court was for specific performance. We find merely that in Pennsylvania an equitable lien would have arisen as a matter of law, and that payment on such a lien would have defeated the trustee's avoidance powers.

In bankruptcy the existence and power of liens is controlled by state law, unless its application would frustrate a federal policy. *In re Taddeo,* 9 Bankr. 299, 305 (Bankr. E.D.N.Y. 1981). Pennsylvania law is applicable when the property in dispute is in Pennsylvania. *See In re Computer Room, Inc.,* 24 Bankr. 732, 736 (Bankr. N.D. Ala. 1982). Pennsylvania law recognizes an equitable lien. The parties stipulated that the property increased in value by $22,600 as the result of the $31,500 which the Diethorns paid to Eaton. Transcript of Hearing, Sept. 30, 1988; App. 128a-129a. This payment was made while the Diethorns occupied the house under a contract of sale and were thus

equitable owners. *See Long John Silvers, Inc. v. Fiore,* 255 Pa. Super. 183, 386 A.2d 569, 572 (1978); *McCannon v. Marston,* 679 F.2d 13, 15 (3d Cir. 1982). The contract failed of performance because of what Eaton, not the Diethorns, did and did not do, and because of the resulting withdrawal of the mortgage commitment. If Eaton were allowed to keep the benefits of the Diethorns' investment, or if the benefits were to return to the estate in bankruptcy, he (or the estate) would enjoy just the sort of unjust enrichment which Pennsylvania's law of the equitable lien forbids. *See* Restatement of Restitution § 161 (1937) (Equitable Lien). We are therefore convinced that under the circumstances of this case, an equitable lien would have arisen.

In cases of this kind, the trustee in bankruptcy possesses only those powers of avoidance which a hypothetical judgment lien creditor would have under state law on the date the bankruptcy petition was filed. 11 U.S.C. § 544. In Pennsylvania a judgment lien creditor of Eaton on that date could not have defeated the claims of a holder of an equitable lien against the property in Allegheny County. *See Gladowski v. Felczak,* 346 Pa. 660, 31 A.2d 718 (1943) (holder of equitable lien on real property has right of subrogation to judgment lien); *Williams v. Benzing,* 53 Pa. D. & C. 559, 562 (Philadelphia County Ct. 1945) (equitable lienholder's rights subrogated to other lien rights when equitable lien is on real property and claims of other lienholders have been satisfied by equitable lienholder). Therefore, if the transfer had not occurred and a chapter 7 distribution had been made instead, 11 U.S.C. § 547(5), the Diethorns would not have joined the other unsecured creditors but would have been paid first, in satisfaction of the lien, from the proceeds of the sale of the property. They

would have received no less than they have in fact received.[3] No federally enacted policy would be frustrated or debilitated by this result, so the application of Pennsylvania's law of the equitable lien controls, dictating judgment for the defendants. *In re Taddeo.* 9 Bankr. 299, 305 (Bankr. E.D.N.Y. 1981). Thus in general, the principles we applied in *In re Gebco Investment Corp.*, 641 F.2d 143 (3d Cir. 1981), control the question of the equitable lien in this case as well.

IV.

The judgment will, therefore, be reversed.

A True Copy:

Teste:

Clerk of the United States Court of Appeals
for the Third Circuit

(A.O. U.S. Courts. G.M.C. Printing. Phila., Pa. 215-568-4264)

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[3]In analyzing the case under section 547(b)(5), the bankruptcy judge offered three sets of calculations to show that the Diethorns as unsecured creditors would have received virtually nothing in a chapter 7 distribution. Mem Op., Dec. 6, 1988, at 6 n. 7; App. 201a. She could have spared herself the trouble. The point is that in a chapter 7 distribution the Diethorns would not have been treated as unsecured creditors at all.

Appendix C

IN THE

United States District Court

FOR THE WESTERN DISTRICT OF PENNSYLVANIA

IN RE:

JOSEPH M. EATON BUILDERS, INC.
Debtor,
JAMES A. LEWIS, ESQ., Trustee
for Joseph M. Eaton Builders, Inc.
Plaintiff/Appellee,

v.

THOMAS J. DIETHORN and
LINDA M. DIETHORN,
Defendants/Appellants.

Civil Action No: 89-584, 89-647

(Bankruptcy No. 87-00765) (Adversary No. 87-0359)

MEMORANDUM OPINION

The instant matter is before the Court on appeal from a final order of the federal bankruptcy court dated December 6, 1988. This Court exercises jurisdiction pursuant to 28 U.S.C. §158(a). Our review of issues of law is *de novo* and findings of fact shall not be set aside unless found "clearly erroneous." *See Paradise Hotel Corp. v. Bank of Nova Scotia*, 842 F.2d 47, 49 (3d Cir. 1988). *See also Crocker National Bank v. American Mariner Industries, Inc.*, 734 F.2d 426, 429 (9th Cir. 1984).

On April 4, 1985, Joseph M. Eaton Builders, Inc. ("Eaton") and Thomas J. Diethorn and Linda M.

Diethorn ("Diethorns"), appellants/defendants, entered an agreement for the sale of a house in Jefferson Borough, Allegheny County, Pennsylvania. At the time of the agreement, the debtor was in the process of completing the residence. Subsequently, the Diethorns paid Eaton $31,514.25 which included $22,600 for improvements. The Diethorns moved into the property pursuant to a lease. The Diethorns demanded that certain defective siding be replaced. After Eaton refused, the Diethorns lost their mortgage commitment and the purchase agreement terminated.

The Diethorns brought an action against Eaton and the suit was indexed as a *lis pendens*, clouding the title to the property. The complaint sought specific performance of the sale and that Eaton escrow money to replace the siding. The Diethorns vacated the property and Eaton sold the property. On February 26, 1987, the Court of Common Pleas of Allegheny County issued a consent order settling the case. In the settlement, Eaton agreed to pay the Diethorns $15,500 and return $3,000 earnest money in exchange for cancelling the *lis pendens*.

On March 3, 1987, Eaton filed a voluntary petition in bankruptcy under Chapter 7 of the Bankruptcy Code. The trustee commenced a preference action and on December 6, 1988 the bankruptcy court directed the Diethorns to pay the trustee the $15,500 obtained in the settlement.

The issue before this Court is whether the $15,500 payment is a preference under section 547 of the bankruptcy code. The Diethorns contend that the $15,500 was money invested in the house and therefore is an equitable lien on the house and that Eaton was unjustly enriched. Additionally, the Diethorns contend that the removal of

the *lis pendens* and the settlement was an exchange for the new value invested in the house.

We find that although the Diethorns' claim may have become a judgment lien, the Diethorns had nothing more than a *lis pendens* against Eaton at the time of settlement. Therefore, the settlement within the statutory period could be considered nothing other than a voidable preference. *See Coral Petroleum, Inc. v. Banque Paribas-London,* 797 F.2d 1351 (5th Cir. 1986). *See also Rialto Publishing Company v. Bass,* 325 F.2d 527 (9th Cir. 1963); *United States of America v. Frank C. Brame,* 243 F. Supp. 29 (D.Idaho 1965); *Pendleton v. Dealer Warehouse, Inc.,* 40 Bankr. 306 (Bankr. W.D.Ky. 1984); *In re: Manuel A. Sierra, M.D.,* 79 Bankr. 89 (Bankr. S.D.Fla. 1987); *In the matter of: John J. Gawel,* 67 Bankr. 662 (Bankr. D.Conn. 1986); *In re: June Elizabeth Isenberg Ressler,* 61 Bankr. 403 (Bankr. E.D. Tenn. 1986); *In re: Owen Carl Bell,* 55 Bankr. 246 (Bankr. M.D.Tenn. 1985). We shall affirm the order of the bankruptcy court.

IN THE

United States District Court

FOR THE WESTERN DISTRICT OF PENNSYLVANIA

IN RE:

JOSEPH M. EATON BUILDERS, INC.
Debtor,
JAMES A. LEWIS, ESQ., Trustee
for Joseph M. Eaton Builders, Inc.
Plaintiff/Appellee,

v.

THOMAS J. DIETHORN and
LINDA M. DIETHORN,
Defendants/Appellants.

Civil Action No: 89-584, 89-647

(Bankruptcy No. 87-00765) (Adversary No. 87-0359)

ORDER

AND NOW, this 12th day of July, 1989, for the reasons set forth in the accompanying Memorandum Opinion,

IT IS HEREBY ORDERED that the order of the bankruptcy court of December 6, 1988 is AFFIRMED.

/s/ GLENN E. MENCER
United States District Judge

cm: All parties of record. RVB

Appendix D

IN THE

United States Bankruptcy Court

FOR THE WESTERN DISTRICT OF PENNSYLVANIA

In Re: JOSEPH M. EATON BUILDERS, INC., *Debtor,*	**Bankruptcy No. 87-00765**
JAMES A. LEWIS, ESQ., *Trustee, Plaintiff,* vs. THOMAS J. & LINDA M. DIETHORN, *Defendants.*	**Adversary No. 87-0359**

APPEARANCES: James A. Lewis, Esq.
James F. Hartzell, Esq.
Counsel for Trustee

J. Kerrington Lewis, Esq.
Lee Markovitz, Esq.
Counsel for Diethorns

MEMORANDUM OPINION

The matter presently before the Court is a Complaint For Avoidance and Recovery for Preferential Transfer filed by the Chapter 7 Trustee, James A. Lewis, Esq., (hereinafter Trustee), against Thomas J. and Linda M. Diethorn (hereinafter Defendants). This is a core proceeding. 28 U.S.C. § 157(b)(2)(F).

Trial commenced on January 26, 1988, the record was reopened, and a hearing was held on September 30, 1988, to permit Defendants to submit evidence in support of their contention that the amounts they paid Debtor for improvements to real estate increased the value of the property and that they were entitled to an equitable lien against the property. Based upon the testimony and evidence produced at trial and the applicable law, the Court finds that the transaction at issue was an avoidable preferential transfer.[1]

FACTS

On or before April 4, 1985, Joseph M. Eaton Builders, Inc. (hereinafter Debtor) as seller, and Defendants, as buyers, executed an agreement with respect to realty located on Springhouse Drive[2] in Jefferson Borough, Allegheny County, Pennsylvania, pursuant to which Debtor was to construct a residence. The total purchase price was $182,400.00. Defendants paid $3,000.00 earnest money to Country Hills Real Estate, the selling agent, secured a mortgage commitment, which was revoked later, and paid Debtor $31,514.25[3] which included $22,600.00 for certain permanent improvements to the realty made at the request of Defendants. The parties stipulated that the value of the

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[1]In his post-trial brief, Trustee advanced an argument under 11 U.S.C. § 548(a)(1) which section sets forth the Trustee's power to avoid a transfer made with actual intent to hinder, delay or defraud creditors. Because this adversary is decided on the basis of 11 U.S.C. § 547, the issue of intent is not reached; however, the Court notes that the Trustee did not raise the § 548(a)(1) issue in his Complaint nor was the issue litigated.

[2]All pleadings refer to the property as 203 Springhouse Drive. The undated agreement of sale identifies the property as Lot 303 Springhouse Drive.

[3]At the hearing on September 30, 1988, the parties stipulated to this amount.

real estate was thereby increased $22,600.00. The remainder was spent for items personal to Defendants, such as a cable television hook-up.

From April through July 10, 1986, Defendants lived in the residence pursuant to a lease but paid rent for only a few days. During that time, Defendants were notified that their mortgage commitment would be revoked because the lender's inspectors believed that the siding was defective. Defendants then instituted a suit in equity against Debtor in the Allegheny County Court of Common Pleas seeking specific performance of the agreement of sale and demanding that Debtor escrow $13,000.00 to cover the estimated costs of replacing the siding. Defendants also requested costs, fees and special damages. Debtor contested the allegations of breach and filed a counterclaim.

Defendants' action was indexed in the Allegheny County records as a *lis pendens* against the real estate but, before trial and for the purpose of avoiding the effects of Debtor's contemplated bankruptcy filing,[4] Defendants' petition to receive payment and to cancel the *lis pendens* was granted by a consent order entered in Common Pleas Court dated February 26, 1987. The consent order continued the cancellation of the *lis pendens* on Debtor paying Defendants $15,500.00 of the proceeds of sale of 203 Springhouse Drive and effecting the return of Defendants' $3,000.00 earnest money. No additional work was done to the property after Defendants vacated the premises in July, 1986, and it was sold to Donald R. and Rita J. Huckles (hereinafter the Huckles) on February 26, 1987, for

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[4]Trustee Exhibit 6. Paragraph 4 of Defendant's Petition to Cancel Lis Pendens states that "[Debtor] is contemplating bankruptcy and [Defendants] seek [ ] to mitigate those damages by cancelling the said Lis Pendens and receiving said monies at this time."

$205,000.00. The addendum to the settlement statement utilized at the closing shows payment to Defendants of $15,500.00 from the sale proceeds.[5] The $3,000.00 earnest money also was returned to Defendants. At the hearing on September 30, 1988, the Trustee withdrew his claim for this amount on the ground that Defendants were entitled to it inasmuch as their mortgage commitment had been withdrawn and, therefore, they had not breached the agreement of sale. The question of whether the siding in fact was defective was never litigated, but, because of our disposition of this adversary, we need not resolve the issue.

On March 3, 1987, Debtor filed a voluntary petition under Chapter 7 of the Bankruptcy Code and, in September of 1987, the instant adversary proceeding alleging an avoidable preferential transfer under 11 U.S.C. § 547 was commenced by the Trustee.

DISCUSSION

The portions of § 547 of the Bankruptcy Code pertinent to this litigation provide:

> (b) Except as provided in subsection (c) of this section, the trustee may avoid any transfer of an interest of the debtor in property—(1) to or for the benefit of a creditor; (2) for or on account of an antecedent debt owed by the debtor before such transfer was made; (3) made while the debtor was insolvent; (4) made (A) on or within 90 days before the date of the filing of the petition . . . ; (5) that enables such creditor to receive more than such creditor would receive if—(A) the case

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[5]It is noted that the Court of Common Pleas docket entry states the amount to be $15,000.00. Inasmuch as the parties agree that Defendants received $15,500.00 from the sale proceeds, the greater figure is used throughout this opinion.

> were a case under chapter 7 of this title; (B) the transfer had not been made; and (C) such creditor received payment of such debt to the extent provided by the provisions of this title.
>
> (c) The trustee may not avoid under this section a transfer—(1) to the extent that such transfer was—(A) intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor; and (B) in fact a substantially contemporaneous exchange . . . .

11 U.S.C. § 547(b),(c).[6]

Defendants are creditors of the Debtor inasmuch as they have a claim against Debtor which arose pre-petition, notwithstanding the fact that Debtor disputed the claim. 11 U.S.C. § 101(9)(A). A debt is a liability on a claim. 11 U.S.C. § 101(11). The payment was made to Defendants on account of this debt within 90 days pre-petition. Defendants did not rebut the presumption that Debtor was insolvent at the time. 11 U.S.C. § 547(f),(g). Furthermore, it is almost certain that there will be no distribution to unsecured creditors and that Defendants have received more than they are entitled to under applicable Code provisions. The transfer is prima facie a preferential transfer avoidable by the Trustee. 11 U.S.C. § 547(b)(5)(C).[7]

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[6]Defendants' pre-trial statement raises the defense that payment to them was in the ordinary course of Debtor's business and, under § 547(c)(2), was not avoidable. This point was not pursued at trial; however, the Court fails to see how payment of a disputed claim is in the "ordinary course" of the business of building houses.

[7]Debtor's schedules show liabilities exceeding assets by $149,343.84. All but $39,365.00 worth of Debtor's assets are subject to first mortgages. Undisputed, unsecured claims in the amount of $186,708.84 and priority wages in the amount of $2,000.00 will compete

(Continued on next page)

Defendants contest the avoidability of the transfer on several grounds. First, Defendants argue that release of the *lis pendens* and payment to them by Debtor constituted a contemporaneous exchange for new value given to the Debtor and therefore is not avoidable by the Trustee. *See* 11 U.S.C. § 547(c)(1)(A). This contention is without merit. "New value" is defined as

> . . . money or money's worth in goods, services, or new credit, or release by a transferee of property previously transferred to such transferee in a transaction that is neither void nor voidable by the debtor or the trustee under any applicable law, including proceeds of such property, but does not include an obligation substituted for an existing obligation . . . . 11 U.S.C. § 547(a)(2).

By virtue of the consent order entered in the state action, Debtor's payment was substituted for the allegedly unfulfilled construction obligation. Such a substitution cannot constitute new value when it is made in settlement of a disputed unsecured claim.

(Continued)

for this amount excluding Defendants' claim, claims of certain other creditors disputed by Debtor, and administrative expenses. In his post-trial brief, the Trustee states that the Debtor's estate consists of $5,665.46 in a bank account, plus a residence with a stated market value of $173,000.00 which, on the date of filing of the petition, was subject to a mortgage balance of $161,000.00. Under either set of figures it is clear that there will be little if anything left for unsecured creditors. The court notes that Schedule A-2 appended to Debtor's bankruptcy petition lists a second piece of real estate valued at $192,000.00 subject to claims of $167,000.00. Both properties were under agreements of sale on the date of filing of the bankruptcy petition but all dollar amounts of record have been considered herein and do not change the conclusion that unsecured creditors will receive little.

Defendants do not expressly so state, but it necessarily is implied that they view the indexing of the *lis pendens*, rather than the payment, as the transfer. Defendants also contend that indexing the *lis pendens* created a lien and that because the *lis pendens* was indexed more than ninety days pre-petition, the "lien" is unavoidable. This argument also is without merit.

Under Pennsylvania law the indexing of a *lis pendens* is not a transfer of rights or liabilities nor does it create a lien. It merely serves as notice to third parties that certain real property is involved in litigation and that any interest in that property which a third party might acquire would be subject to the results of the underlying litigation. *Dice v. Bender*, 383 Pa. 94, 117 A.2d 725 (1955). *See also U.S. National Bank v. Johnson*, 506 Pa. 622, 487 A.2d 809, 812 (1985); *Houston-Starr Co. v. Virginia Mansion Apartments*, 295 Pa. Super. 480, 441 A.2d 1334, 1335 n.1 (1982); *Blumenfeld v. R. M. Shoemaker Co.*, 286 Pa. Super. 540, 429 A.2d 654, 657-58 and n.8 (1981); *McCahill v. Roberts*, 421 Pa. 233, 219 A.2d 306, 308 (1966).[8] Furthermore,

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[8]The history and purpose of *lis pendens* were set forth in footnote 8 in *Blumenfeld*, 429 A.2d at 657-58, as follows:

> "In *McCahill v. Roberts*, 421 Pa. 233, 219 A.2d 606 (1966) our Supreme Court discussed the nature and effect of a lis pendens:
>
> 'Lis pendens literally means a pending suit . . .
>
> 'Lis pendens is construed to be " . . . 'the jurisdiction, power or control which courts acquire over property involved in a suit, pending the continuance of the action, and until its final judgment therein' ": *Bungar v. St. Michael's Greek Catholic Ch.*, 272 Pa. 402, 404, 116 A. 389 (1922). The initial basis of the application of the doctrine was one of constructive notice to all the world of the pending litigation: *Diamond v. Lawrence County*, 37 Pa. 353 (1861). In later years, the courts determined that the doctrine was one of policy only,
>
> *(Continued on next page)*

removal of a *lis pendens* does not terminate the underlying litigation nor does it fix or determine the parties' rights or obligations. *U.S. National Bank v. Johnson, supra,* 487 A.2d at 812.

In the alternative Defendants assert that whether or not they have a lien on property by virtue of the *lis pendens,* they have a lien which is equitable in nature. The claim of an equitable lien is based on two theories. The first is that the $22,600.00 worth of permanent improvements to the house, which they paid for, is in the nature of a mechanics lien which, if properly perfected, is not avoidable by the Trustee. *See* 11 U.S.C. § § 101(47), 545, 546(b); 49 P.S. § 1101 *et. seq.* Defendants are in error. Under Pennsylvania law, mechanics liens are statutory while equitable liens are creations of equity at common law which do not arise by operation of statute and, until judgment, are unperfected and avoidable by the Trustee. *See* 11 U.S.C. § 544. *See also In re Allegheny International, Inc., et al.,* Bankr. No. 88-00448, Motion Nos. 88-1405-M, 88-1723-M (W.D. Pa. Oct. 26, 1988). Even if Defendants' claim is in the nature of a mechanics lien, it is unperfected and, therefore, avoidable. *See Associated Lumber & Mfg.*

(Continued)

> i.e., it would be unfair and an insult to the courts to permit the severance of rights in a property which they were then in the process of deciding: *Dovey's Appeal,* 97 Pa. 153 (1881). Having determined that the doctrine was founded on a policy, rather than conceptual basis, the next logical step was to decree the use of equitable principles in the application of the rule. This point was reached in *Dice v. Bender,* 383 Pa. 94, 117 A.2d 725 (1955), wherein we held that the doctrine does not establish an actual lien on the affected property, but rather merely gives notice to third parties that any interest that may be acquired in the property pending the litigation will be subject to the result of the action. *Id* at 237-38, 219 A.2d at 308 (footnote omitted).

Co. v. Mastroianni, 173 Pa. Super. 310, 98 A.2d 52 (1953) (lien is lost if statutory procedures are not complied with). *See also Joseph M. Eaton Builders, Inc. by Trustee v. Custom Heating Co.,* Slip Op. at 4-5, Bankr. No. 87-00765, Adv. No. 87-00358 (Bankr. W.D. Pa. March 23, 1988), and cases cited therein.

Defendants next argue that they have an equitable lien because Debtor was unjustly enriched by the increased price paid at the time of the second sale.[9] The parties stipulated that the additional $22,600.00 paid by the Huckles was the direct result of improvements paid for by Defendants.[10] Defendants contend that this constitutes unjust enrichment of Debtor. Defendants did not raise this contention until the hearing on September 30, 1988; however, the court notes that the mere fact that the property sold in 1987 for an amount in excess of the original sales price established in 1985 does not prove that Debtor was unjustly enriched. Debtor was in a position to seek another

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[9]Defendants assert that this equitable lien transforms their claim from an unsecured claim to a secured one, and, therefore, the transfer at issue is unavoidable by the Trustee. The court reiterates the tenet that until judgment is entered, a claim to an equitable lien is an unsecured claim. Defendants cite *Gladowski v. Felczak,* 346 Pa. 660, 31 A.2d 718 (1943), which involved a lender who, in good faith, lent the grantee of a third entity an amount sufficient to pay off the grantor's judgment lien and restore premises which had been demolished. The lender took back a mortgage and the grantee rehabilitated the property. Subsequently the grantee's title was found to be illegal and void and the lender requested that its mortgage be declared a lien on the property against the third party grantor. *Gladowski* is distinguishable from the instant case in that the lender held an unavoidable security interest, as that term is defined in the Bankruptcy Code, in the form of a mortgage. *See* 11 U.S.C. § 101(45).

[10]Although the parties stipulated that the increased price was due to improvements paid for by Defendants, the Court is not entirely convinced that the passage of time and changes in market conditions were not factors. However, we need not resolve this point.

purchaser for the property only because the Defendants did not obtain a mortgage commitment. That Defendants' expenditure is the subject of an unsecured claim is the result of the combination of the facts and law applicable to this case and, while unfortunate for Defendants, is unchangeable by the Court and does not constitute unjust enrichment to Debtor.

The fact that the property was sold for $22,600.00 more than Defendants' contract price indicates that the alleged defect in the siding, if it existed at all, was not so significant that another lending company would not grant a mortgage or that another buyer would be unwilling to purchase the property absent substantial alteration. Under the circumstances any enrichment of Debtor was not unjust. Too, Defendants could have elected to continue the action for specific performance in the Court of Common Pleas of Allegheny County. They did not so choose. Instead, they abandoned their claim for specific performance and accepted a settlement payment on a disputed claim. In so doing, Defendants admitted a classic breach of contract scenario which can give rise to only an unsecured claim.

In re Pribonic, 70 B.R. 596 (Bankr., W.D. Pa. 1987), addresses the question of whether an agreement of sale constituted an executory contract which could be rejected by the Trustee. The court determined that, absent a decree for specific performance, rejection of the sales agreement left the buyer with only a claim for damages for breach of contract. *Id.* at 604. Where a right to an equitable remedy such as specific performance can be converted to a right to payment, there exists a claim cognizable under the Bankruptcy Code. *Id.* at 604-05. *See*, 11 U.S.C. § 101(4). Absent

perfection, the claim is unsecured. *See Allegheny International, Inc., supra,* at 7-8.

Based on the foregoing, the Court finds that the Trustee is entitled to recover the preferential payment made to the Defendants in the amount of $15,500.00, which sum excludes hand money paid by Defendants. The Court notes that the merits of the underlying contractual dispute are not before the Court and nothing in this Opinion is to be construed to be a determination of same; rather, this Opinion is limited to finding that the payments made to effect the removal of the *lis pendens* were preferential and that Defendants failed to establish that they are entitled to an equitable lien, that an equitable lien exists, or that any equitable lien which may exist is not avoidable under 11 U.S.C. § 544. The Trustee, therefore, has the right to that portion of the proceeds of sale now in Defendants' possession.

An appropriate Order will be issued.

/s/ JUDITH K. FITZGERALD
Judith K. Fitzgerald
U.S. Bankruptcy Judge

Dated: December 6, 1988

cc: JAMES A. LEWIS, ESQ.
JAMES F. HARTZELL, ESQ.
J. KERRINGTON LEWIS, ESQ.
LEE MARKOVITZ, ESQ.
United States Trustee
SCHAFFLER & BOHM

IN THE

United States Bankruptcy Court

FOR THE WESTERN DISTRICT OF PENNSYLVANIA

In Re: JOSEPH M. EATON BUILDERS, INC., *Debtor,*	**Bankruptcy No. 87-00765**
JAMES A. LEWIS, ESQ., *Trustee,* *Plaintiff,*	
vs.	**Adversary**
THOMAS J. & LINDA M. DIETHORN, *Defendants.*	**No. 87-0359**

ORDER

And now, to-wit, this 6th day of December, 1988, for the reasons expressed in the Memorandum Opinion of this date, it is hereby ORDERED, ADJUDGED AND DECREED that judgment in the amount of $15,500.00 be and hereby is rendered for Trustee. James A. Lewis, Esq., on his Complaint for Avoidance and Recovery for Preferential Transfer against Thomas J. and Linda M. Diethorn;

It is further ORDERED, ADJUDGED AND DECREED THAT Thomas J. Diethorn and Linda M. Diethorn shall remit the sum of $15,500.00 to Trustee within 60 days hereof.

It is further ORDERED, ADJUDGED AND DECREED that Thomas J. Diethorn and Linda M. Diethorn shall have 90 days hereof to file a proof of claim for an unsecured debt.

BY THE COURT

/s/ JUDITH K. FITZGERALD
Judith K. Fitzgerald
U.S. Bankruptcy Judge

cc: JAMES A. LEWIS, ESQ.
JAMES F. HARTZELL, ESQ.
ROTHMAN, GORDON, FOREMAN & GROUDINE
300 Grant Building
Pittsburgh, PA 15219
Counsel for Trustee

J. KERRINGTON LEWIS, ESQ.
LEE MARKOVITZ, ESQ.
LEWIS & STOCKEY
1040 Fifth Avenue
Pittsburgh, PA 15219
Counsel for Diethorns

United States Trustee
319 Federal Building
Pittsburgh, PA 15222

SCHAFFLER & BOHM
967 Liberty Avenue
Pittsburgh, PA 15219
Counsel for Debtor (For informational purposes)

Appendix E

IN THE

United States Bankruptcy Court

FOR THE WESTERN DISTRICT OF PENNSYLVANIA

In Re: JOSEPH M. EATON BUILDERS, INC., *Debtor,*	**Bankruptcy No. 87-00765**
JAMES A. LEWIS, ESQ., *Trustee, Plaintiff.* vs. THOMAS J. & LINDA M. DIETHORN, *Defendants.*	**Adversary No. 87-0359**

COMPLAINT FOR AVOIDANCE AND RECOVERY FOR PREFERENTIAL TRANSFER

COMES NOW, James A. Lewis, Esquire, Plaintiff herein, by and through his counsel, Rothman, Gordon, Foreman and Groudine, P.A., and states as and for his claim against Thomas J. and Linda M. Diethorn, the above-named Defendants, the following.

JURISDICTION

1. Jurisdiction over this action is conferred upon this Honorable Court by 28 U.S.C. Section 1334 and 28 U.S.C. Section 157 as this action is a core proceeding arising in or related to the case under Title 11 of the United States Bankruptcy Code, known as Joseph M. Eaton Builders,

Inc., which proceedings are presently pending at the above-stated case number.

VENUE

2. Venue is proper in this judicial district under 28 U.S.C. Section 1409.

BACKGROUND

3. On or about March 23, 1987, Joseph M. Eaton Builders, Inc. commenced a Voluntary Petition under Chapter 7 of the United States Bankruptcy Code before this Honorable Court.

4. Subsequent to the commencement of said proceedings, James A. Lewis, Esquire was appointed to serve as Trustee in said proceedings.

PARTIES

5. Plaintiff is James A. Lewis, Esquire, who has been duly appointed, has qualified and who serves as Trustee in these proceedings.

6. Defendants are Thomas J. and Linda M. Diethorn, individuals residing in the Commonwealth of Pennsylvania, whose last known address is 5241 Elmore Drive, Pittsburgh, PA 15227.

FACTS

7. On or about May 8, 1986, Defendants commenced an action in equity against the Plaintiff, and, caused the same to be indexed "lis pendens" against a property owned by the Debtor located at 203 Springhouse Drive, Jefferson Borough, Allegheny County, Pennsylvania 15025.

8. On or about February 27, 1987, the Debtor sold said real estate to Donald R. and Rita J. Huckle for a

stated consideration of $205,000.00. The deed evidencing such transaction is of record in the Allegheny County Recorder of Deeds, Deed Book Volume 7501, Page 505.

9. In order to sell said property free of the lis pendens hereinabove noted, Debtor agreed to pay to the Defendants the sum of $18,500.00, and the Defendants agreed to release their alleged claim to the aforementioned property.

10. On September 4, 1987, Plaintiff made demand upon the Defendants for return of the monies paid to the Defendants as set forth in Paragraph 9 hereinbefore. The Defendants have failed and refused to make the repayment demanded by the Plaintiff.

CLAIM

11. Plaintiff is advised, believes and avers that the transaction above described constituted a transfer of an interest of the Debtor in property to or for the benefit of Defendants, alleged creditors of the Debtor, for or on account of an antecedent debt owed by the Debtor before such transfer was made. Further, said transfer was made while the Debtor was insolvent; was made on or within ninety (90) days before the date of the filing of the original petition in these proceedings and enabled the Defendants to receive more than they would have received if the case were a case under Chapter 7 of the United States Bankruptcy Code, the transfer had not been made and Defendants had received payment of such debt to the extent provided by the applicable provisions of the United States Bankruptcy Code.

WHEREFORE, Plaintiff respectfully requests this Honorable Court to grant judgment against Defendants in the amount of $18,500.00, with interest thereon at the legal rate from September 4, 1987, together with costs of suit

and further requests this Honorable Court to grant such other and further relief as it shall seem just and proper.

ROTHMAN, GORDON,
FOREMAN & GROUDINE, P.A.

By: /s/ J. HARTZELL
James A. Lewis, Esquire
300 Grant Building
Pittsburgh, PA 15219
(412) 281-0705
Attorneys for Plaintiff

Appendix F

IN THE

Court of Common Pleas

OF ALLEGHENY COUNTY, PENNSYLVANIA

THOMAS J. DIETHORN, and
LINDA M. DIETHORN, his wife,
Plaintiffs,

v.

JOSEPH M. EATON, t/d/b/a
JOSEPH EATON BUILDERS,
Defendants.

Civil Division
No: G.D. 86-8206

Petition To Cancel Lis Pendens

Code:
Filed on behalf of Thomas J. Diethorn and Linda M. Diethorn, his wife, Plaintiffs

Counsel of Record for these Parties:

J. Kerrington Lewis, Esq.
PA I.D. #15575

Lewis and Stockey
Firm #161
1040 Fifth Avenue
Pittsburgh, PA 15219

(412) 391-0818

NOTICE OF PRESENTATION

To: Rose, Schmidt, Chapman, Duff & Hasley
Attention: THOMAS W. CORBETT, Esquire
& KIM D. EATON, Esquire
900 Oliver Building
Pittsburgh, PA 15222-5369

PLEASE TAKE NOTICE that the original of the attached Petition to Cancel Lis Pendens will be presented before The Honorable Marion K. Finkelhor located at 706 City-County Building, Pittsburgh, Pennsylvania 15219 on the 24th day of February 1987, at 1:15 o'clock P.M. or as soon thereafter as suits the convenience of the Court.

LEWIS AND STOCKEY

/s/ J. KERRINGTON LEWIS
J. Kerrington Lewis, Esquire
Attorney for Plaintiffs

CERTIFICATE OF SERVICE

I, J. KERRINGTON LEWIS, Esquire, do hereby certify that a true and correct copy of the within Petition was served upon the following designated persons by hand delivery.

To: ROSE, SCHMIDT, CHAPMAN, DUFF & HASLEY
Attention: THOMAS W. CORBETT, ESQUIRE
& KIM D. EATON, ESQUIRE
900 Oliver Building
Pittsburgh, PA 15222-5369

Dated: February 23, 1987

. . . /s/ J. KERRINGTON LEWIS . . . .
J. Kerrington Lewis, Esquire
Attorney for Plaintiffs

PETITION TO CANCEL LIS PENDENS

AND NOW, comes the Plaintiffs, THOMAS J. DIETHORN and LINDA M. DIETHORN, his wife, by their attorneys, the law firm of LEWIS AND STOCKEY, and files the following *Petition To Cancel Lis Pendens* and in support thereof avers:

1. Plaintiffs filed the above-captioned Equity case and indexed a Notice of Lis Pendens.

2. The subject property is now under Agreement of Sale between Defendant and third parties.

3. Plaintiff is willing to cancel the Lis Pendens indexed providing Plaintiff receives $15,500.00 from the proceeds of the Defendant's sale to said third parties and providing Defendant releases Plaintiffs' $3,000.00 in Escrow monies now being held by Country Hills Real Estate.

4. Defendant is contemplating bankruptcy and Plaintiff seeks to mitigate those damages by cancelling the said Lis Pendens and receiving said monies at this time.

WHEREFORE, Plaintiff respectively requests the Court to cancel the Lis Pendens.

Respectfully submitted,
LEWIS AND STOCKEY

/s/ J. KERRINGTON LEWIS
J. Kerrington Lewis, Esquire
Attorney for Plaintiffs

IN THE

Court of Common Pleas

OF ALLEGHENY COUNTY, PENNSYLVANIA

THOMAS J. DIETHORN, and
LINDA M. DIETHORN, his wife,
Plaintiffs,

v.

JOSEPH M. EATON, t/d/b/a
JOSEPH EATON BUILDERS,
Defendants.

No: G.D. 86-8206

ORDER OF COURT

AND NOW, TO-WIT, this 26th day of February, 1987, it is ordered that the Lis Pendens indexed in the above-captioned case be stricken provided Plaintiff receives the $15,500.00 from the sale of the subject property on or before March 5, 1987, and provided the Defendant cause the Three Thousand ($3,000.00) Dollars now being held in Escrow by Country Hills Real Estate to be paid over to the Plaintiffs.

This Motion is Consented
To By Defense Counsel

BY THE COURT

/s/.....
Attorney for Defendant

/s/ WEKSELMAN, J.

Case No. GD 86-8206
Filed: February 26, 1987, 3:23 P.M.

Certified Copy From The Record

/s/ JOHN P. JOYCE
Prothonotary

/s/ MARTHA CLOVER
Deputy

Appendix G

IN THE

Court of Common Pleas

OF ALLEGHENY COUNTY, PENNSYLVANIA

THOMAS J. DIETHORN, and
LINDA M. DIETHORN, his wife,
Plaintiffs,

v.

JOSEPH M. EATON, t/d/b/a
JOSEPH EATON BUILDERS,
Defendant.

Civil Division
No: G.D. 86-8206

Complaint In Civil Action—Equity
Real Estate Involved
Code: 020

Filed on behalf of Thomas J. Diethorn and Linda M. Diethorn, his wife, Plaintiffs

Counsel of Record for this Party:

J. Kerrington Lewis, Esq.
PA I.D. #15575

Lewis and Stockey
Firm #161
1040 Fifth Avenue
Pittsburgh, PA 15219

(412) 391-0818

IN THE

Court of Common Pleas

OF ALLEGHENY COUNTY, PENNSYLVANIA
CIVIL DIVISION

THOMAS J. DIETHORN, and
LINDA M. DIETHORN, his wife,
Plaintiffs,

v.

JOSEPH M. EATON, t/d/b/a
JOSEPH EATON BUILDERS,
Defendant.

No.

COMPLAINT IN CIVIL ACTION—EQUITY

NOTICE TO DEFEND

You have been sued in court. If you wish to defend against the claims set forth in the following pages, you must take action within twenty (20) days after this complaint and notice are served, by entering a written appearance personally or by an attorney and filing in writing with the court your defenses or objections to the claims set forth against you. You are warned that if you fail to do so the case may proceed without you and a judgment may be entered against you by the court without further notice for any money claimed in the complaint or for any other claim or relief requested by the plaintiff. You may lose money or property or other rights important to you.

YOU SHOULD TAKE THIS PAPER TO YOUR LAWYER AT ONCE. IF YOU DO NOT HAVE A LAWYER OR CANNOT AFFORD ONE, GO TO OR TELEPHONE THE OFFICE SET FORTH BELOW TO FIND OUT WHERE YOU CAN GET LEGAL HELP.

LAWYER REFERRAL SERVICE
THE ALLEGHENY COUNTY BAR ASSOCIATION
920 CITY-COUNTY BUILDING
PITTSBURGH, PENNSYLVANIA 15219

COMPLAINT IN CIVIL ACTION
EQUITY

AND NOW, come the Plaintiffs, THOMAS J. DIETHORN and LINDA M. DIETHORN, his wife, by their attorney, J. KERRINGTON LEWIS, ESQUIRE, who file the following Complaint in Equity and in support thereof aver:

1. The Plaintiffs are adult individuals who reside at 5241 Elmwood Drive, Pittsburgh, Allegheny County, Pennsylvania 15227.

2. The Defendant JOSEPH M. EATON t/d/b/a JOSEPH EATON BUILDERS, is an adult individual who either resides or does business at 121 Point View Road, Pittsburgh, Allegheny County, Pennsylvania 15227.

3. On or about November 27, 1985, the Plaintiffs and the Defendant entered into a written agreement wherein Plaintiffs agreed to purchase from Defendant a lot with residential dwelling to be erected by Defendant situated at 203 Springhouse Drive, Waterman Farm Estates, Jefferson Borough, Allegheny County, Commonwealth of Pennsylvania 15025. (A true and correct copy of the Agreement of Sale and Addendum Agreement of Construction are

attached hereto and marked exhibit "A" and incorporated herein by response.)

4. At the time of the execution of the Agreement of Sale and construction the Plaintiffs disclosed to Defendant that they were selling their existing home from which proceeds would be applied to pay a substantial part of the consideration required under the Agreement described in Paragraph 3 above and the parties executed the Agreement with this understanding.

5. Plaintiffs have sold their present home and have vacated on April 25, 1986. Additionally, Plaintiffs have secured a mortgage commitment, stand ready to fully perform, and have access to the funds necessary to consumate settlement under the Agreement described in Paragraph 3 above.

6. Defendant has asserted he has completed the construction of the dwelling house but his performance is in material breach of the written Agreement in that he has failed to supply and attach to the dwelling cypress siding and other wood materials of the quality and the nature promised or implied under the Agreement. The reasonable estimate of costs to replace same and bring the dwelling into compliance with the terms of the written Agreement exceeds THIRTEEN THOUSAND ($13,000.00) DOLLARS.

7. Because of the unique nature and qualities of the wood materials and the time required to cure his performance, Defendant cannot comply with the Agreement before Plaintiffs are required to deed their present home to their buyer and vacate the premises.

8. Despite Plaintiffs reasonable and seasonable offer to consumate the sale with THIRTEEN THOUSAND

($13,000.00) DOLLARS of the sales proceeds being withheld from disbursement and placed in escrow pending the replacement of the defective wood heretofore installed, Defendant has wrongfully refused to accede to Plaintiffs' requests and refuses to consumate any sale unless the total consideration for land purchased and construction are tendered without reduction.

9. The Defendants' refusal to consumate the sale without escrowing the funds necessary to cure his defective performance under the construction terms of the Agreement constitutes a material repudiation and anticipatory breach.

10. If Defendant is not directed to close the transaction with placement of funds in escrow, the Plaintiffs will incure the following damages:

(a) Loss of their mortgage commitment thereby possibly causing them to pay higher interest as well as additional loan application and closing fees and forefeiture of funds heretofore paid on account for the present financing.

(b) Alternatively causing Plaintiffs to incure the expenses of curing Defendant's defective performance and costs of litigation to recoup the same.

11. Plaintiffs have no adequate remedy in law but to request the intervention of this Court to enforce the terms of the sole construction Agreement with placement of funds in escrow in the amount and for the purposes heretofore described.

WHEREFORE: Plaintiffs' pray:

(a) That the Defendant be decreed to specifically perform the Agreement, and to convey the property to

Plaintiffs with THIRTEEN THOUSAND ($13,000.00) DOLLARS being placed in escrow pending resolution of the matters appertaining to curing the performance arising from supplying defective cypress siding and other wood materials.

(b) That the Defendant be enjoined specially until hearing and thereafter perpetually from granting, conveying or exumbering said real estate with improvements to any person other than Plaintiffs.

(c) Granting Plaintiffs such other relief as the Court deems appropriate including an award for costs, attorney fees, and special damages.

Respectfully submitted,

/s/ J. KERRINGTON LEWIS

J. Kerrington Lewis, Esquire
Attorney for Plaintiffs